

Fixed Income – July 2013



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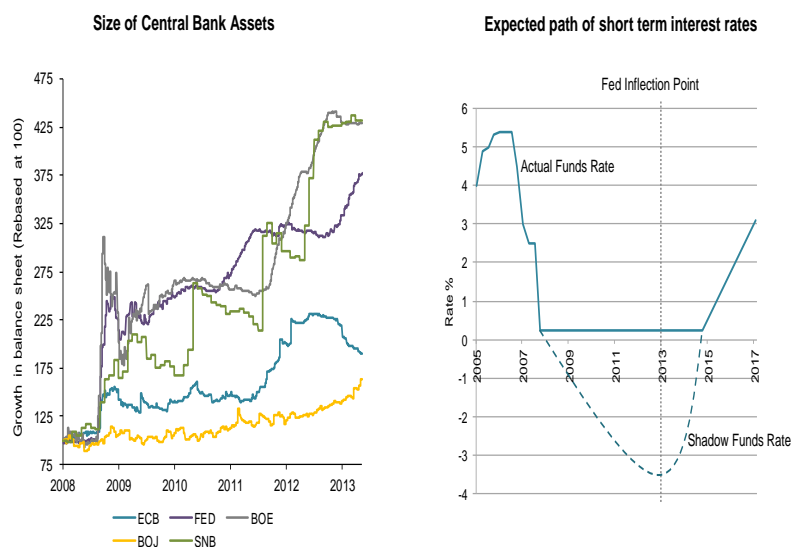
Playing poker with policymakers

The traditional relationship between inflation, GDP growth and the performance of Fixed Income products has broken down. In the past two to three years, it has become the weakest that I have seen in the 30 years spent covering the asset class. This is because policy actions have become the key driver of markets over the past five years, acting at times to both suppress and heighten volatility.

Central Bank injections of liquidity have until recently reduced uncertainty, but we are now returning once again to an era of heightened volatility. This might feel alarming, but it is not necessarily bad news for investors. After all, the orientation of monetary policy will simply move from being 'hyper-accommodative' to merely 'accommodative', as figure 1 below shows.

In spite of the prospect of quantitative easing (QE) tapering and then ending in the US in 2014, we certainly do not expect interest rates to rise quickly in the coming months. Indeed, there is ample scope for monetary policy to remain relatively loose for a considerable period of time and the background for markets will thus remain positive. Consequently, our message is that risk assets remain attractive.

Figure 1: Tapering is not tightening



Source: Threadneedle June 2013, Bloomberg June 2013.

However, it is important to remember that some of the measures undertaken by the world's largest economies are economic experiments. There are clearly risks associated with these experiments and it remains to be seen how markets will react as the influence of recent policy actions slows and fades.

In the case of Japan, its commitment to QE is an experiment on a vast scale, significantly larger in relative terms than the easing that has already been undertaken in the US. The authorities are trying to inject enough money into the economy to create inflation. Japan could do with some inflation and we believe that it will achieve this goal, although it is our view that inflation is unlikely to go as high as the authorities' 2% target.

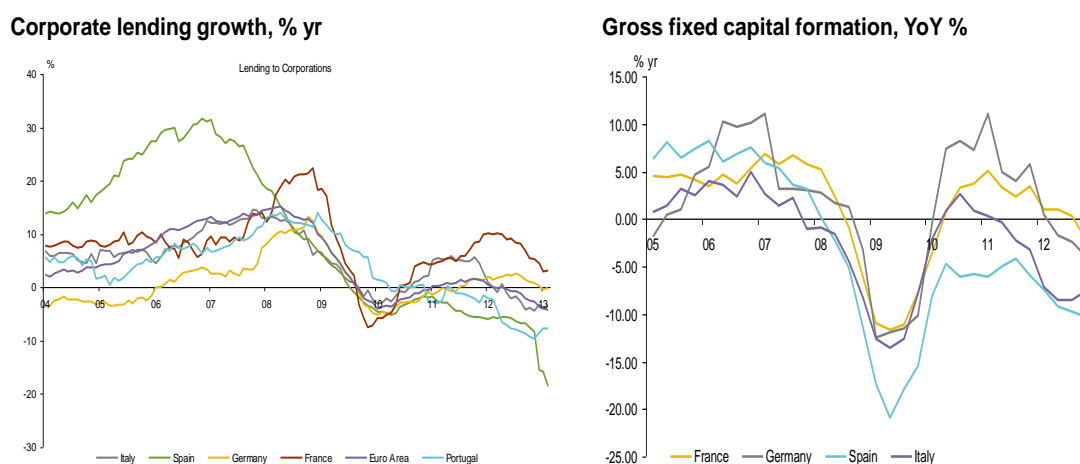
China suffering from previous policy errors

Looking around the world, the Chinese economy also faces some very serious challenges. Beijing has made many good decisions in the past decade, but it has also made one serious policy error in not deregulating its financial sector. This has allowed a mis-allocation of credit, with poorly-performing companies able to access cheap finance. It may well be that many of these underperformers should really no longer be in business. Prior to its recent actions, the Chinese authorities have been slow to tighten monetary policy. We believe China will not make any significant contribution to global growth until the government addresses the consequences of previous policy errors – and that may take some time.

In Europe, the search for growth remains elusive. Support for peripheral economies continues but political risk remains. Meanwhile, resistance against austerity, which is not the answer to Europe's problems, is growing and we are now seeing some change in the direction of policy. The question is whether the relief will arrive in time with both Italy and Spain on the verge of a sharp, downward economic spiral.

For Europe, the launch of the Outright Monetary Transactions programme in the autumn of 2012 was very important but monetary policy remains too tight in a number of countries. The credit impulse (the change in new credit issued as a % of GDP) is about to turn deeply negative and policymakers need to act to resolve this problem. There is plenty of evidence indicating that private sector demand, and thus overall economic growth, is very closely correlated with the private sector credit impulse. European policymakers must boost liquidity or face even more serious issues in the not too distant future. Real standards of living also need to fall dramatically – by around 25-30% if Europe is to regain its competitiveness. However, the outlook is not necessarily bad for European firms and their earnings potential. Those companies focused on exports, for example, can continue to fare well, even in difficult times.

Figure 2: The credit impulse in Europe is about to turn deeply negative



Source: Threadneedle, Reuters EcoWin, BI+ Bloomberg, March 2013.

In emerging economies, the challenge is managing currencies that are under pressure from the rising US dollar, but this is draining FX reserves and hence tightening monetary policy. However, many of these countries remain relatively safe credits and we still prefer emerging market debt over developed world debt. Indeed, we believe the asset class has been oversold recently.

The world of excess liquidity and inadequate growth that we have seen over the past few years has benefited corporates, while wage earners have suffered. We do not believe this situation is going to change. This is partly why our strategy continues to favour corporate credits over their sovereign counterparts. The fact that we are likely to remain in a low growth world also means that the case for owning emerging market and high yield bonds remains valid, although it is not as strong as it once was.

Increasing volatility should provide a boon for active managers

At one time, the case for owning government bonds was clear. They would provide balance in a portfolio, rising when other asset classes came under pressure. However, anticipated returns mean that government bonds currently no longer play that hedging role. But we do not believe that radically altering the risk profile of a portfolio is the way to address the way in which the characteristics of the asset class have changed. While we must accept that returns are likely to be lower, we believe that fixed income still has an important role to play within a well-diversified portfolio. The search for yield, for example, is not going to go away as interest rates are likely to remain low for a considerable period of time. We also believe that we are likely to see volatility increase, and that this will create a raft of opportunities for active managers in the coming months.

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